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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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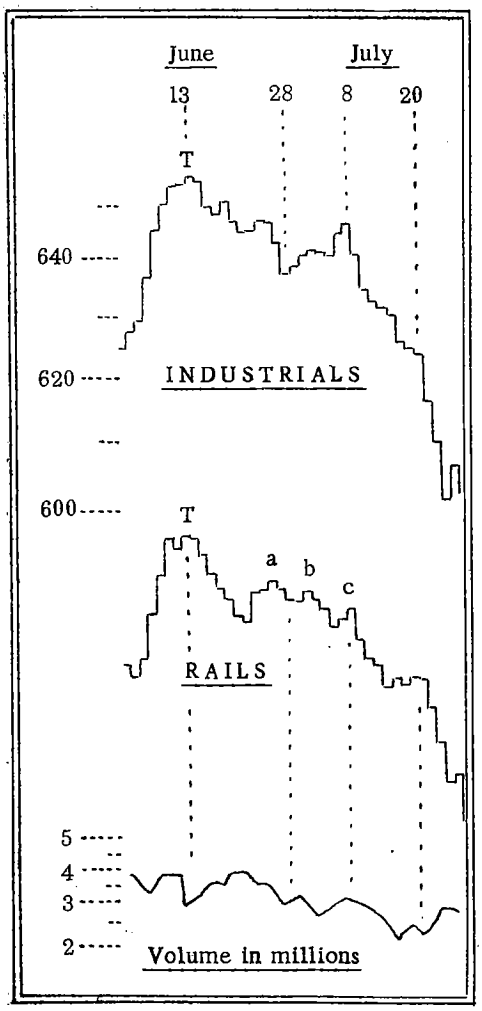
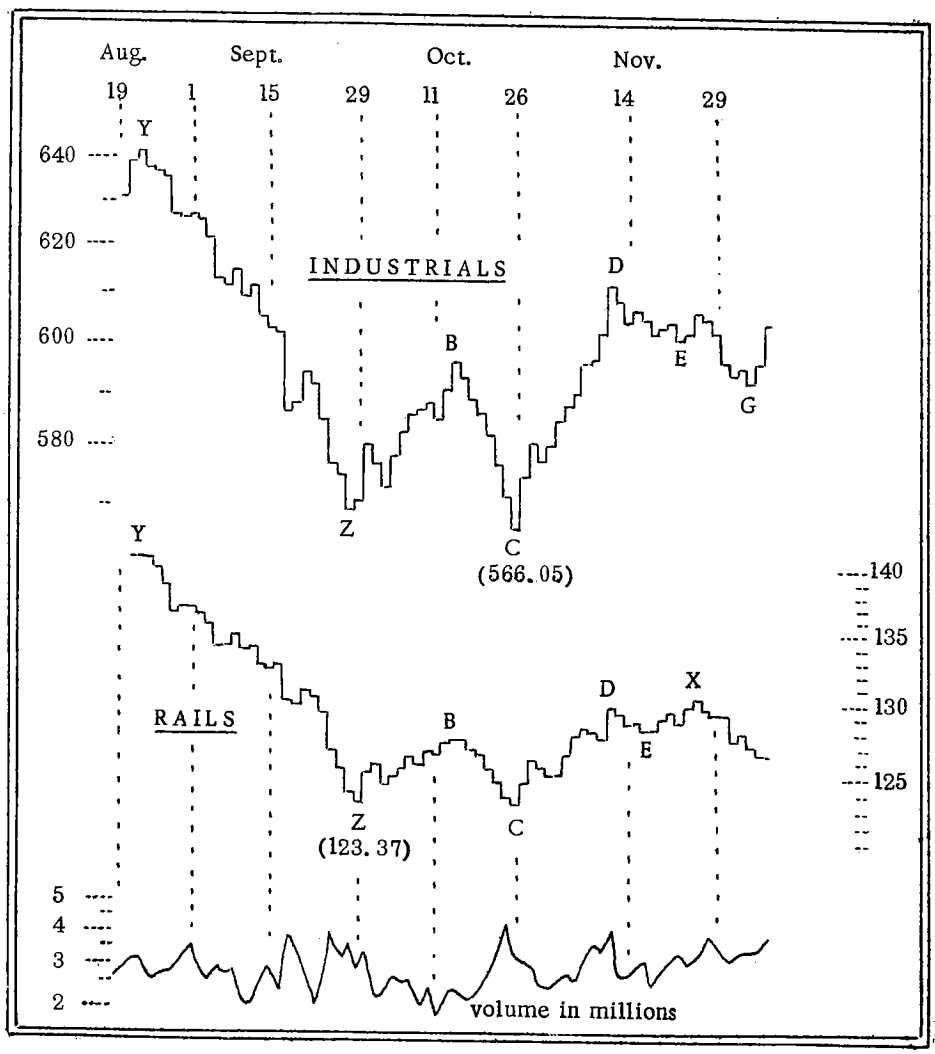
"Whenever, in an area where a reversal might normally be expected to develop, the Averages begin disagreeing, extreme caution is indicated. A great majority of trend changes, both of primary (long term) and secondary (the trend of several weeks' or months' duration) importance, occur as an aftermath of some kind of divergence in the Averages. This may be recognized by a tendency of one Average to advance on days when the other declines, or the inability of one Average to confirm the other in the penetration of a previously established high (or low) point." (Robert Rhea)

During a given bull or bear market, price patterns often repeat themselves. Although there is no certainty that each situation will work out in exactly the same way, the recent November-December formation bears such a marked resemblence to the June peak that I believe a comparison of the two structures is warranted (see charts). Note that in June the two Averages recorded their highs at T, then declined as volume expanded. Following the lows of June 28, Industrials embarked on a little rally which ended with the sharp advance of July 7 and 8. During this rally Rails diverged, forming three minor descending peaks (a, b, c). Finally, on July 9, both Averages fell away rapidly as volume expanded.





In the present situation the two Averages established recovery highs at D. Following the Industrial peak at D (612.01), that Average turned weak and retreated in a series of minor descending zig-zags. During the same period Rails showed diverging tendencies. The carrier index rallied to a new high at X (130.13), and this high was, of course, not confirmed by Industrials. Subsequently, both Averages declined, and the preceding lows at E were jointly penetrated. Attention was directed to this penetration in Letter 125. From their December 5 low of 593.49 (G), Industrials rallied sharply, but this time the Rails diverged. On December 6 Industrials rose 3.62 while Rails declined 0.48. On December 7 Industrials surged 7.51 but Rails declined 0.03. Volume remained high on both days (3.36 and 3.66 million shares respectively).

The price action of December 7 and 8 represents the most dramatic divergence of the two Averages since late 1959. If the Industrials now confirm the Rail weakness by turning down and violating point G (593.49) on increasing volume, the danger signals will be flying. Conversely, if both Averages can hurdle their preceding highs (Industrials at D - 612.01, Rails at X - 130.13) we will have the most impressive pattern of the year. In case of the latter, all shorts should be closed out.

TECHNICAL INDICATORS and CONTRARY OPINION In a past Letter I mentioned two factors which are a constant consideration during a bear market: (1) will business conditions and corporate profits continue to deteriorate in the foreseeable future, and (2) if the answer is yes, has the worst already been discounted in the price structure? The first factor is fundamental and must be answered by the economist or the statistician; the second factor is technical and must be answered by the market analyst or the investor.

It was Hamilton's expressed opinion that "...everything that anybody knows about anything with even a remote bearing on finance finds its way into Wall Street in the form of information; the stock market itself, in its fluctuations, represents the sifted value of all this knowledge." Although Hamilton and Rhea often commented upon such things as investor sentiment, low-priced stock action, phases, short interest, etc., they always gave precedence to the movements of the Averages. They believed, in fact, that the Averages discounted the entire technical situation.

A great many statistics are available today which were not available in the 1920's and 1930's. Many of these statistics (i.e. odd-lots, advance-declines, short interest, etc.) are both interesting and important, and I frequently comment about them in these Letters. I have devoted a good deal of time to the study of the various technical indicators, and I believe that many of them can be quite useful if they are properly employed and interpreted. Nevertheless, I also believe that the safest procedure is to adhere to the original Dow Theory method of giving top priority to the movements of the Averages themselves.

The question might then be asked: "Why bother with the technical indicators at all? Why not just watch the Averages?" The answer is that the movements of the Averages are always an effect, not a cause, and it is hoped that by studying the technical indicators some clues may be uncovered as to the underlying psychology of the market. For in the final analysis, stocks move in response to investors' sentiments (psychology) regarding the future trend of earnings and business.

If, for instance, the market has discounted the worst that can be seen ahead, then regardless of how bad the business news becomes, one or both Averages should hold above the preceding lows. In such a situation, the more bearish the general psychology, the more impressive is the situation (assuming the Averages do not penetrate the lows). Technical considerations such as odd-lots, short interest and contrary opinion then become valuable for measuring the psychology of the market and the sentiment of investors.

There are certain times when the technical indicators are "in gear" with the primary trend of the market. Such situations are particularly important when they can be fitted into the general framework of a "contrary opinion". For example, during late 1957 and early 1958 the odd-lots were selling on balance, the short interest was increasing, the market was moving sideways and forming a base, and against all this the business picture

was steadily deteriorating. This resulted in the widely-held opinion that the market "was going to collapse". In other words, in late 1957 the technical position of the market and the pattern of the Averages were running contrary to both the general market opinion and the general psychology of the country.

Letter 125 compared the 1957 situation with that of today. There is a very important difference between the two periods, and it is this: there is no bullish contrary opinion position today. Actually, today's almost unanimous opinion holds that "the adjustment" will be over by early or at least mid-1961, following which the economy will again turn up. If this is to be the case then we should be in for an extended market advance beginning in the next few weeks or months.

From the bullish standpoint, however, there are two large "flies in the ointment"; they are (1) the pattern of the Averages, which does not (at least at this writing) suggest a primary reversal and a new bull market, and (2) the concept of "contrary opinion", which states that when too many people believe that something is going to happen, that "something" is already discounted and is therefore unlikely to occur.

An interesting example of the validity of contrary opinion can be seen in the following rather pathetic sequence. This sequence concerns business psychology throughout 1959 and 1960: (1) The steel strike is now over. 1960 will see the greatest boom in history. (2) Well, it won't be the greatest boom ever, but the economy will hold at peak levels. (3) We were a little too optimistic in January, but things will remain in "high gear" for the rest of 1960. (4) Frankly, it could be better, but we expect things to pick up right after the summer holidays. (5) There seems to be some sort of "adjustment" going on, but inventories are at "rock bottom". Since inventories can't go any lower, an October-November rise is "in the bag". (6) Actually its a mild "dip", but it will be forgotten by Spring, 1961. (7) All right, call it a recession, but it's going to be the gentlest of all the post-war recessions, and it will be over by mid-1961.

Thus we see that contrary opinion has lead the facts, and the facts have lead the forecasts throughout 1960. It is also obvious that there has been a general inability to believe that anything could possibly interrupt the great 1958-59 boom. As things stand now, it seems to me that an extended market rise would fall too easily into the mold of what the majority of amateur and professional opinion expects. Of course the market and general psychology can change; if this happens we will discuss it further.

In the current (December 12) issue of U.S. News and World Report there is an extremely interesting study. This study consists of interviews with 709 members of the Investment Bankers Association (the Association met in Florida last month). According to U.S. News only 14% of the bankers believed that the D-J Industrials would be below the 550 level in mid-1961, only 22% of the bankers thought the broad trend of stock prices would be down during most of 1961 and only 9.7% of the bankers foresaw any sort of business decline during 1961. Such statistics should give any bullish investor pause for thought.

FOR THE BENEFIT OF BULLS There is little profit in trying to outguess the Averages. At times I have felt personally bearish, yet because of the action of the market I wrote bullishly. At other times I have been optimistic, but since I promise to provide clients with my interpretations of Dow's Theory (not my own hopes or wishes), I wrote bearishly. In the vast majority of cases the Averages have proved to be correct.

The recent business news has featured disheartening unemployment statistics, the corporate profit squeeze, dividend cuts, commodity price declines, the gold outflow and a variety of other bearish factors. In the face of all this it will be most interesting to see whether the Industrial Average can continue to hold above the 548 level (the level which I discussed in the Special Study of Dow's 50% Principle). If Industrials can hold stubbornly above the halfway point of the 1957-59 advance (548), and if the market can gather great

technical strength as Industrials hold, then the situation will brighten considerably. It is still too soon to draw any valid conclusions, however, and I urge readers to exercise (in Dow's words) "the patience of six men." (Copies of the 50% Principle will be sent to new subscribers on request, no charge. Please include large, self-addressed stamped envelope.)

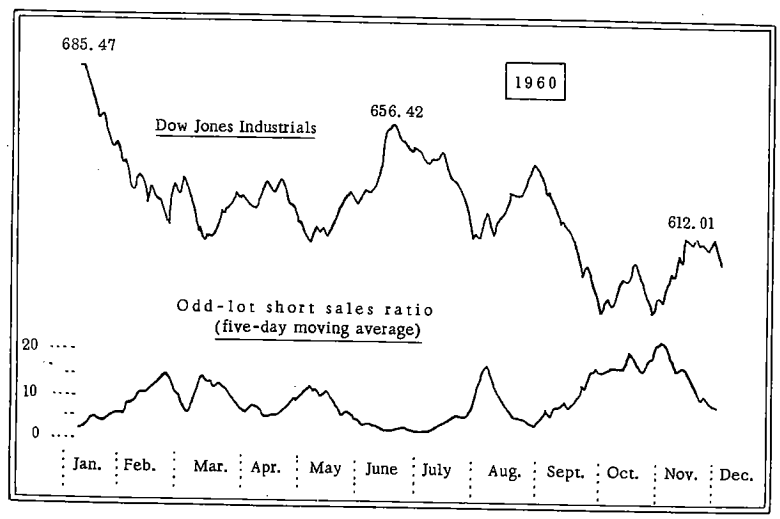
ODD-LOT SHORTS The odd-lot (under 100 share) trader is very often wrong, at least in the short-term sense. Most investors are under the impression that the odd-lotter is always wrong, but this is not the case. The odd-lotter tends to be most wrong at important market turns. Sooner or later, however, the odd-lotter will get with the trend. For instance, at the top of a long advance the odd-lot trader is apt to be buying heavily while the odd-lot short seller is holding his activity to a minimum. As the market declines the odd-lotter may step up his purchases (stocks appear to be "a buy" as they go down), but if the market continues to fall the odd-lotter will eventually swing back to the cautious side. The odd-lot short seller is generally inactive near the peak of an advance; he seems to need the spectacle of dropping prices in order to work up enough courage to short the market. When the odd-lot short's activity becomes excessive, it is usually a sign that the end of the decline is near.

Note on the chart that odd-lot shorting picked up sharply near the decline lows of February, March, May, August, September and November. Each of these odd-lot shorting peaks proved to be a temporary bottom for the market.

At the end of October the odd-lot short figure rose to 24 (see chart), and this represented the heaviest rate of odd-lot shorting of the year. However, 24 is not an excessive rate when judged against past figures. For example, near the major secondary bottom of October, 1957, the odd-lot ratio rose to 34.

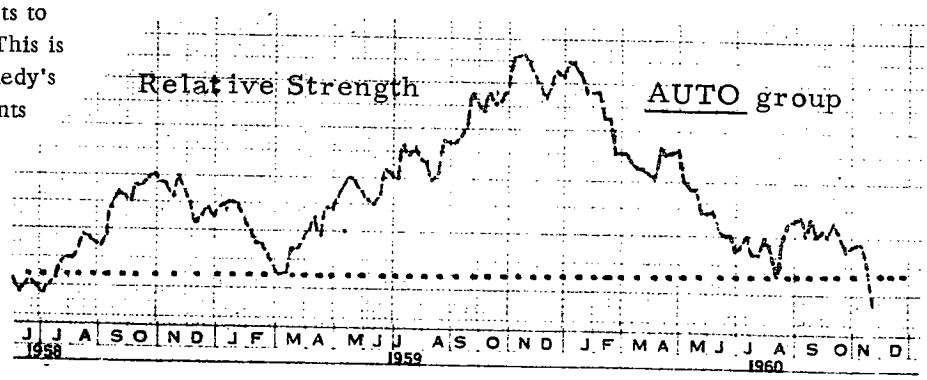
This particular chart is composed according to the method developed by Garfield Drew. The figures appear as a ratio of odd-lot short sales to total odd-lot sales, and these rati are then charted as a five-day moving Average (in order to smooth out the movements).

RELATIVE STRENGTH The automobile stocks, which represent the nation's most important industry, are looking particularly poor on a relative strength basis. The chart shows the relative strength pattern of the auto group from from mid 1958 to last week. Note the plunge to a new low in relative strength since June of 1958. This would seem to belie all the talk about the auto sales records of October and November. The market seems to be saying that there is something wrong with the sales figures, the profits or both. The relative strength shown here is derived by charting the ratio of the auto group price and the Standard and Poor "500" Stock Index.



FROM ELIOT JANEWAY "The Kennedy Administration is looking forward to taking office with full knowledge of the change in the direction now depressing the economy - not only here at home, but abroad as well. It expects to come to power as a depression Administration. This is at least part of the meaning behind Senator Kennedy's statement of policy that he will have no statements of policy to make - or responsibility to share - until January 20."

(Written, Thursday, Dec. 8th, 2 P.M.)



Charts courtesy of Traders Research, P.O. Box 6185, Lambert Airport, Missouri